2018 Fourth Quarter Review

"In the short run, the market is a voting machine. In the long run, it is a weighing machine."
- Benjamin Graham (father of value investing)

It was widely reported that US stocks suffered their worst December since the Great Depression when, last month alone, the broad S&P 500 fell 6.6% CAD. Similarly, Canada's S&P/TSX Composite was down 5.4%. And global stock markets suffered, with most finishing 2018 in "correction" territory, defined as a decline from recent peaks of at least 10%. **Daily volatility was a key feature, giving investors a sharp reminder of how quickly stock prices can move in unpredictable ways**.

For the quarter, the S&P/TSX Composite lost 10.1%, leaving it down 8.9% for the year. **Canada's energy sector struggled** as our oil prices (WCS) tumbled before climbing back up slightly by year end. 2018 also saw the rise and fall of cannabis share prices - when recreational cannabis was legalized in October, many investors took profits on overvalued cannabis stocks, prompting a quick sell-off. And for the fifth time since mid-2017, the Bank of Canada (BoC) raised interest rates a quarter point in October to 1.75%, but held rates steady in December, citing somewhat weaker economic data.

In the US, the tech-heavy **NASDAQ Composite Index entered "bear-market" territory** on December 21st, defined as a decline of at least 20% from its top. The S&P 500 fared better, but was still down 8.7% CAD on the quarter and up only 4.3% CAD on the year (helped by the weakened Canadian dollar). Events in Washington weighed on Wall Street: stalled trade talks with China and others, unwelcome Cabinet resignations and contentious relations between the White House and newly-elected Democrats which resulted in a partial government shutdown. To cap it off and, despite incipient economic headwinds, in late December the Federal Reserve (the Fed) lifted US interest rates to a range of 2.25% to 2.50%.

Overseas, **evidence of slowing growth in China** became more worrisome. Their GDP growth has slowed to 6.5% annually compared to above 10% in the past. The protracted trade conflict with the US, slower retail sales and moderating industrial production dragged Chinese stocks lower. **In Europe, a Brexit deal was at an impasse, even though the UK is set to leave the EU on March 29th, 2019**. Amid these troubles, last quarter international and emerging market stocks were down 7.7% and 1.1% CAD, respectively.

The turmoil in global equity markets prompted many investors to seek safer havens, including fixed income, the Japanese yen and gold. Bond prices benefited, with yields down slightly: short-term government bonds returned 1.4% CAD for the quarter.

Following are the returns for major indices for the period ended December 31st, 2018:

	4th quarter actual	YTD actual	1 year actual	3 year annualized	5 year annualized	10 year annualized
Canadian Short Term (FTSE 30-Day T Bill)	0.4	1.3	1.3	0.8	0.8	0.7
Canadian Bonds (FTSE Short Term Bond)	1.4	1.9	1.9	1.0	1.7	2.5
Canadian Stocks (S&P/TSX Comp.)	-10.1	-8.9	-8.9	6.4	4.1	7.9
U.S. Stocks (S&P 500)	-8.7	4.3	4.3	8.8	14.0	14.4
Non-North American Dev. Stocks (EAFE)	-7.7	-6.0	-6.0	2.4	5.7	7.5
Emerging Markets Stocks (FTSE / MSCI Emerging)*	-1.1	-7.1	-7.1	7.1	6.6	9.2

* 4th quarter, YTD, 1-year, 3-year, and 5-year returns are FTSE Emerging. 10-year returns are MSCI Emerging. All returns in Canadian dollars. Source: SS&C Technologies and Vanguard

Outlook

"The intelligent investor is a realist who sells to optimists and buys from pessimists."
- Benjamin Graham

After December's market rout and January's early rebound, the year begins with investors having a lot more questions than answers. Until late 2018, markets seemed to be quite content to sweep obvious "problems" under the rug, but finally the confluence of risks that had been building for a long time hit home: US-stoked trade wars, reduced corporate-earnings guidance, rising interest rates, worry about Brexit and the slowing Chinese economy, to name the headliners. The real surprise is not that a correction happened, but how long it took to arrive. And, until some of these issues get resolved, **markets in the near term are likely to remain jumpy**.

US-listed companies account for close to 55% of the world's stocks, so the outlook for America impacts the well-being of global equity markets in a big way. As of now, that picture is not rosy; **many economists expect a US recession - possibly within a year**. Their concerns include ongoing trade wars, further rate hikes by the Fed, political gridlock in Washington and lower business investment once the windfall from last year's $1.5 trillion tax cut rolls off. That said, responsible policy makers can mitigate damage from the first three, at least.

With respect to the Fed, the **White House is advocating a shift to more accommodative monetary policy**. Despite these pressures, however, the Fed has rightly maintained its independence, taking direction from economic data. Higher rates may be a drag on growth today, but it's important to note that they provide the Fed with "ammunition" down the road when it might really be needed, and we can expect quick action should conditions change.

In Canada, the economic worries of last year will likely persist through 2019. In November, the federal government announced measures to address Canadian competitiveness, but these have been criticized as inadequate in recapturing lost business investment. GM's recent announcement to close its flag-ship Oshawa plant this year provides evidence of the problem. In the West, the alarming oversupply of Canada's oil has risen to as much as 200,000 barrels per day. While Alberta's government intervention to shrink the discount on WCS is helpful temporarily, it is clear that new pipelines are essential for long-term economic health; **tough obstacles remain**.

Meanwhile, the BoC shows no sign of easing interest rates even though consumers have record levels of debt, the housing market is jittery, Alberta's economy languishes, industrial growth in our largest business hubs is under pressure and export demand from the US, our largest trading partner, is expected to fade. **Our prediction: the health of Canada's economy will be a principal campaign topic in this year's federal election.**

In Europe, political turmoil, ongoing trade issues and worrying financial conditions dampen the outlook for 2019. Economic growth is expected to slacken somewhat and there is mixed news on the political front. Italy has reached a fiscal deal with the European Commission, providing much-needed relief to its debt holders. But in France, reform efforts have run into resistance, forcing concessions to protesters. However, it is the UK's long and messy Brexit negotiation that is likely to garner most investor attention - possibly well beyond the March deadline. Deal or no deal?

The uncertainty in emerging-market economies may continue as well. Exporters like China, South Korea and Taiwan, which account for close to 60% of the asset class, will suffer as long as the trade disputes with the US last. In addition, tighter US monetary policy boosts the US dollar, making it punitive for nations that rely on foreign investment to service their dollar-denominated debt.

Is there a silver lining to be found? Yes. This latest market rout, with its unpleasant volatility, **restores value and provides investors with renewed opportunities**. US price/earnings multiples are coming back in line with historical averages. In particular, Canadian and emerging-markets stocks look compelling at current prices. We have the assurance that central bankers, having been battle-tested over the last 10 years, stand ready to take accommodative action if required. So, while there are many issues creating investor anxiety as we start this year, **it only takes one major "good news" headline to shift market perspective**. It is uncertainty that frays nerves; that is not a permanent condition.

Portfolio Strategy

Let's review some history: since 1926, the S&P 500 has declined more than 10% from peak to trough over 150 times, approximately once every year and a half. It has declined more than 20% almost 40 times during the same period. But in the recent past, markets enjoyed a long, very unusual period of relative calm. Perhaps that's the reason current volatility is rattling investors so much: we are somewhat "out of practice". In fact, **equity returns last quarter are not uncommon historically**, just not seen much in the past 10 years. We say this not to diminish the significance of recent declines, but rather to provide some reassurance in historical context.

In previous Notes we have cautioned that market volatility would likely increase, given ongoing major trade disputes and rising interest rates. Certainly, until policy makers provide clear direction on those, market ambivalence will probably persist. One somewhat unexpected development has been the **underperformance of small-company value stocks relative to large-company growth stocks**. The strong performance of technology (growth) stocks during the past few years resulted in their lofty, even indefensible valuations: their retreat makes sense. Value stocks, however, sold off too, and their underperformance is harder to justify. A contrarian would see opportunity.

No one knows where markets go in 2019. Regardless of opinions, even well-considered ones, the future is always a mystery. What matters most for investors is **sticking to a longer-term policy allocation that makes sense in both rising and declining markets**. There will be a few times, like last year, when a 2% return on fixed income looks better than the equity return. Nevertheless, for long-term investors, the best opportunity for success will be found in **maintaining a well-diversified global equity portfolio balanced with a suitable amount of fixed income**. You may be sure of that.